

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

74-2442^{1Rk}

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

WILLIAM H. REID,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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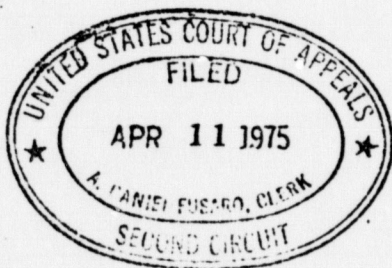


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ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly found that a portion of the unexplained deposits taxpayer made to his checking account represented unreported income derived from his real estate business, and that his understatements of income were due to negligence or disregard of the rules and regulations governing the reporting of income.

STATEMENT OF THE CASE

William H. Reid (taxpayer) appeals from the decision of the United States Tax Court, entered on September 27, 1974, determining income tax deficiencies in the total amount of

\$9,533.39 and statutory additions to tax totalling \$476.67^{1/} for the years 1968 and 1969. (Docket Entries, p. 2.) The memorandum findings of fact and opinion of the Tax Court (Honorable C. Moxley Featherston), filed on July 16, 1974, is reported at P-H Memo T.C., par. 74,185. (Op. 1-11.) Taxpayer timely filed his notice of appeal on November 4, 1974. (Docket Entries, p. 2.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The facts of this case may be summarized as follows:

During 1968 and 1969, the years in issue, taxpayer was employed as a New York City fireman. Taxpayer also was a self-employed real estate broker. As a licensed real estate broker, taxpayer listed apartments and houses for rent or sale, showed the listed property to prospects, attempted to negotiate the lease or sale, and appeared at contract signings and title closings. For these services, taxpayer received a commission of one-month's rent on a lease or six percent of the sales price for consummating a sale. Taxpayer, in addition to his commission on the rentals, often received a deposit equal to one-month's rent which he paid to the lessor. If another agent was involved in the transaction, the commission taxpayer received was divided between taxpayer and that agent. Likewise, if another agent was involved in the sale of a house, a portion of taxpayer's

1/ Appellant's unpaginated appendix consists of the opinion of the Tax Court and the Tax Court Docket Entries. References hereinafter are to the documents comprising the original record on appeal.

commission on that sale was paid to the agent involved.

(Op. 3, 3.)

Taxpayer with other individuals, also purchased houses for cash, improved them, and sold them. In these transactions, taxpayer acted as banker for the others, handling all cash, paying all expenses, and distributing the proceeds to the other individuals involved. (Op. 4.)

On April 19, 1968, taxpayer was involved in an automobile accident and sustained serious head injuries. Taxpayer was placed on sick leave from the fire department for 59 days, light duty for ten months, terminal leave for two and one-half months, and subsequently retired from the fire department because he was no longer able to travel by public conveyance and was in danger of further injury due to unsteadiness and a fear of falling. (Op. 4-5.)

Following the automobile accident, taxpayer played a less active role in the real estate businesses. However, he continued to receive commissions, to take deposits, and to act as banker for the speculative activities. (Tr. 21; Exs. 8, 9.) The business activity was handled by a sales person and an attorney with whom taxpayer was associated. (Op. 5.) Taxpayer testified his only activity was to sign checks. (Tr. 21.)

Taxpayer maintained only one checking account during the years in suit and placed all funds he received into that account. Taxpayer's only sources of funds in 1968 and 1969 were his salary (and later his disability pension payments) from the fire department and funds received from his real estate activities. Deposits to this account totalled \$23,466.92 and \$48,965.47 during 1968 and 1969, respectively. Taxpayer both paid his personal living expenses and made disbursements in connection with his real estate activities from his checking account. (Op. 5.) Taxpayer continued to use this account in connection with his real estate activities subsequent to his accident. (Tr. 21.)

Taxpayer used notations made on his 1968 and 1969 desk calendars to compute his gross income from his real estate business for those years. However, he threw those calendars away at the end of each year. While taxpayer retained canceled checks to verify his claimed business expenses, he disposed of those checks which would substantiate claimed disbursements to other parties. Finally, although he often gave receipts for deposits he received for rental apartments, he presented none at trial. (Op. 5-6.)

Upon audit, the Commissioner recomputed taxpayer's gross income on the basis of taxpayer's bank deposits during the years involved and determined deficiencies for both 1968 and 1969. (Op. 6.) The Commissioner also determined that the underpayment of the tax was due to negligence or failure to maintain adequate records and added the five-percent penalty

provided by Section 6653(a) of the Internal Revenue Code of 1954 to the deficiency. (Op. 1.)

Taxpayer timely petitioned the Tax Court for a redetermination of the deficiencies and at trial attempted to show the majority of his deposits were not taxable income. He introduced schedules he had prepared (Exs. 8, 9; Tr. 11, 58) which purported to separate his bank deposits between taxable and nontaxable receipts. He testified (Tr. 47) that he had prepared these schedules during the week prior to trial and that he did not recall any of the specific deposits. Taxpayer also testified, in response to a question by the court (Tr. 39-40):

THE COURT: * * * Where did you get the information with respect to all this whole list of deposits?

THE WITNESS [taxpayer]: What is my source? Okay. * * * My source is reading from the [bank] statements; that's my source. In addition to that, just how it appears to me and [from] ensuing disbursements from the deposit date; it gives me a picture. In addition to that -- that's one source. My experience, and the facts as they appear to me to be; that's it. No first-hand information; none. That's why it's so difficult.

THE COURT: In other words, you did not have any personal recollection of any one of these deposits?

THE WITNESS: Not one.

THE COURT: And you have no personal recollection of the manner in which the deposit was disbursed?

THE WITNESS: Only from what I can glean from the statements.

THE COURT: And the entire statement, then, is based upon what you think is most likely to have been the true situation?

THE WITNESS: That is correct.

The Tax Court found that the schedules were not accurate. (Op. 10.) Considering the record as a whole, however, the court determined that some of taxpayer's deposits had not constituted income to him. It found that only \$5,600 of the approximately \$7,000 in unexplained deposits for 1968 and only \$15,000 of the approximately \$34,000 in unexplained deposits for 1969 represented unreported income. (Op. 7.) The court further found that the underpayment was due to negligence or intentional disregard of the rules and regulations. It therefore held taxpayer liable for the additions to tax under Section 6653(a) of the Internal Revenue Code of 1954. This appeal followed.

SUMMARY OF ARGUMENT²

The Tax Court properly found that taxpayer had realized \$5,600 and \$15,000 more income during the years 1968 and 1969, respectively, than he reported on his tax returns for those years. Taxpayer's bank deposits during this period vastly exceeded the gross income he reported for taxation. The Commissioner determined that the unaccounted for deposits represented unreported income and assessed deficiencies accordingly.

At trial, taxpayer conceded that he had no records to account for his apparently excessive bank deposits, but introduced schedules of deposits and disbursements which, he testified, indicated that most of the excessive deposits represented nonincome items, e.g., apartment and house deposits,

commissions that he had paid over to other real estate agents, and his fellow-venturers' investments in certain joint ventures taxpayer directed. The Tax Court, while finding that taxpayer's schedules of deposits and disbursements were not accurate, found that certain of taxpayer's bank deposits did stem from nonincome sources and reduced the deficiencies in accord with its best estimate of those nonincome amounts.

The Tax Court properly determined that taxpayer's proof at trial was not sufficient completely to satisfy his burden of proving the Commissioner's determination incorrect. The only tangible evidence taxpayer introduced were schedules of deposits, which had been prepared five years after the transactions at issue and with a view toward trial, were, at least in part, inconsistent with taxpayer's prior explanations of the excessive deposits and, as taxpayer conceded, were not based upon any specific knowledge or recollection of the banking transactions therein recorded, but only upon speculation and assumption. The Tax Court had no choice but to find that these schedules were not accurate. However, the Tax Court accepted taxpayer's testimony that certain of his deposits did not represent income and made as close an estimate of the extent of taxpayer's nonincome receipts as it could under the circumstances. We submit that it could have borne more heavily against taxpayer than it did on the basis of this record. But in no way did the Tax Court err in finding that taxpayer realized \$5,600 and \$15,000 in unreported income during the two years in suit.

Taxpayer gave it no evidence upon which it could have based any smaller findings of unreported income.

The Tax Court was also correct in sustaining the Commissioner's determination that the underpayments of taxes here in issue stemmed from taxpayer's negligence or intentional disregard of the rules and regulations governing the reporting of income and therefore properly sustained his imposition of the five-percent penalty under Section 6653(a) of the Internal Revenue Code of 1954. Taxpayer conceded at trial that he had long since destroyed substantially all his records as to the years in issue. This concession alone justifies imposition of the five-percent penalty.

ARGUMENT

THE TAX COURT CORRECTLY FOUND THAT A PORTION OF THE UNEXPLAINED DEPOSITS TAXPAYER MADE TO HIS CHECKING ACCOUNT REPRESENTED UNREPORTED INCOME HE HAD DERIVED FROM HIS REAL ESTATE BUSINESS AND THAT HIS UNDERSTATEMENTS OF INCOME WERE DUE TO NEGLIGENCE OR DISREGARD OF THE RULES AND REGULATIONS GOVERNING THE REPORTING OF INCOME

A. Unreported Income

Taxpayer, a fireman and real estate broker during the years in issue, reported having received approximately \$16,000 in gross income during 1968 and approximately \$14,700 in gross income in 1969. His bank records, however, reflected that he had made deposits totalling nearly \$7,000 and \$34,000 in excess of the reported income amounts during those same two years. Taxpayer had no records to explain the apparent discrepancy between reported income amounts and his bank deposits, so the Commissioner issued a deficiency notice based upon the theory that taxpayer's unexplained bank deposits represented unreported income amounts.

Taxpayer then petitioned the Tax Court to redetermine the deficiency. He testified (Tr. 9) that he had used his bank account in his real estate business and that the unexplained deposits did not represent unreported income realized from his real estate business, but, instead, represented nonincome items, e.g., apartment deposits that he was obligated to turn over to his landlord/clients, commissions payable to other real estate agents, investments in and proceeds from joint ventures he and some fellow speculators had engaged in.

The Tax Court accepted taxpayer's testimony in part and found that a portion of the unexplained deposits actually represented nonincome items. Cf. Cohan v. Commissioner, 39 F. 2d 540 (C.A. 2, 1930). It went on to find, however, that the remainder of the unexplained deposits represented income items which taxpayer had not reported for taxation. Accordingly, the Tax Court sustained the deficiencies in income taxes determined by the Commissioner with respect to those unreported income amounts. We submit that the Tax Court's determinations of income are correct and should be sustained.

Notices of deficiency issued by the Commissioner are, of course, presumptively correct. Welch v. Helvering, 290 U.S. 111, 115 (1933); Helvering v. Taylor, 293 U.S. 507, 515 (1935). This presumption applies with equal force to deficiency notices based upon analyses of a taxpayer's bank deposits as it does to more conventionally based deficiency notices. Armes v. Commissioner, 448 F. 2d 972 (C.A. 5, 1971). And, of course, unexplained bank deposits do form an adequate ground for the determination of a deficiency. Zeeman v. United States, 395 F. 2d 861 (C.A. 2, 1968); Halle v. Commissioner, 175 F. 2d 500, 503 (C.A. 2, 1949); Hague Estate v. Commissioner, 132 F. 2d 775 (C.A. 2, 1943); Gobins v. Commissioner, 18 T.C. 1159, 1168 (1952).

There is no dispute here that taxpayer's bank deposits greatly exceeded his reported gross income for each of the years in issue. It is further undisputed that taxpayer retained no records which could reconcile the apparent discrepancy between those deposits and the amounts returned for taxation. Instead, all taxpayer offered in order to meet his burden of proof was a schedule of deposits and disbursements (Exs. 8, 9) which he had prepared the week prior to trial, some five years after the close of the last year in issue. He explicitly admitted in response to the court's questions that he had no recollection of any of the specific banking transactions which formed the core of the case against him and which the schedule attempted to explain (Tr. 40):

THE COURT: In other words, you did not have any personal recollection of any one of these deposits?

THE WITNESS: Not one.

THE COURT: And you have no personal recollection of the manner in which the deposit was disbursed?

THE WITNESS: Only from what I can glean from the [bank] statements.

THE COURT: And the entire statement [taxpayer's schedules of deposits and disbursements, Exs. 8 and 9], then, is based upon what you think is most likely to have been the true situation.

THE WITNESS: That is correct.

Taxpayer's testimony thus provided no specific information that would have compelled a lowering of the deficiency determined by the Commissioner. The sources taxpayer gave for certain of

the deposits listed in the schedule may, moreover, not have been consistent with those he had forwarded when dealing with Internal Revenue Service employees. (Tr. 32-39.) Indeed, there are certain indications in the testimony that the deficiency determined by the Commissioner had been based upon an overly generous assumption. In computing the deficiency, the Commissioner had assumed that taxpayer deposited all his fire department pay checks in his bank account and therefore subtracted the amount of taxpayer's net pay from his gross bank deposits in determining the amount of taxpayer's total income. (Op. 7.) However, taxpayer testified that he did not always deposit the full amount of his pay checks in his bank account (Tr. 18):

THE COURT: Why the variation in the paychecks from \$260.72 to \$295.72?

THE WITNESS: For a couple of reasons. One is, sometimes overtime is included. Sometimes x-number of dollars is deposited and a portion taken off; like if, the full check is, say, \$500.00 and I want \$200.00, I will deposit the paycheck as a \$300.00 item then, and take off \$200.00.

We submit that the Tax Court had no choice but to sustain the portion of the Commissioner's determination that it upheld. As that court found (Op. 9-10), taxpayer's schedules of deposits and disbursements were prepared with a view toward trial, were based upon assumption and speculation rather than knowledge and, finally, were not consistent with the explanations taxpayer had given prior to trial. The court therefore had more than sufficient grounds for not finding those schedules accurate. Indeed,

those factors would have provided the Tax Court with sufficient grounds to reject taxpayer's testimony in its entirety and to sustain the deficiency originally determined by the Commissioner. However, it chose to accept taxpayer's testimony in part and to reduce the determined deficiency on the basis of its best estimate of what might actually have transpired during the years in issue. Taxpayer can hardly complain now of the court's actions. In the absence of specific proof to overcome the presumptive correctness of the Commissioner's determination, the Tax Court's estimation of nontaxable deposits could well have borne much more "heavily" than it did against this taxpayer, "whose inexactitude is of his own making." Cohan v. Commissioner, supra, p. 544. *Chesh*

Taxpayer, however, asserts that the Tax Court committed reversible error below. He first asserts (Br. 2) that the court erred in holding that he had been actively engaged in the real estate business after his accident. He concedes (Br. 2), at the same time, that he realized income from his real estate activities after the accident. Indeed, taxpayer's own tax returns (Op. 3) and schedules of deposits and disbursements (Exs. 8 9) graphically indicate that taxpayer had an ongoing involvement in his real estate business during the two years in issue. And the Tax Court itself recognized some of taxpayer's real estate income subsequent to the accident stemmed from the activities carried on by his associates. (Op. 5.)

Taxpayer asserts (Br. 3) that the Tax Court could not properly have found that he realized unreported income during the years in issue because, as reflected in his bank statements, he had not made any significant accumulations in wealth during those years. This argument must fall of its own weight. Taxpayer introduced no proof to show that he had not invested the unreported income in other assets or even to show that his standard of living comported only with reported income amounts. Taxpayer's attempts to point to his net worth do not therefore provide a basis for concluding that he had not realized the unreported income which the Tax Court found he had received. Instead, and especially in light of the nature and quality of the evidence taxpayer was able to muster, the Tax Court was as generous toward him as it could be when it found that only a portion of his unexplained deposits constituted unreported income. See Halle v. Commissioner, supra.

B. The five-percent penalty

The Tax Court sustained the Commissioner's determination that the deficiencies in taxes here at issue were due to either negligence or intentional disregard of the rules and regulations and accordingly upheld his imposition of five-percent penalties pursuant to Section 6653(a) of the Internal Revenue Code of 1954, Appendix, infra. This holding is clearly correct.

Taxpayer testified (Tr. 54) that he maintained some records on a desk calendar each year and then prepared his tax return using the notations on that calendar and his cancelled checks. After the preparation of his return, the calendar for that year

and the checks were destroyed. (Tr. 54-55.) Section 6001 of the Internal Revenue Code of 1954, and Section 1.6001-1(a) and (e) of the Treasury Regulations on Income Tax (1954 Code) (both Appendix, infra) require taxpayers to maintain permanent records which will allow the Internal Revenue Service to verify and establish the amounts of gross income and deductions. Taxpayer's destruction of his records quite clearly violates this requirement and constitutes an intentional disregard of the regulations under Section 6001 justifying imposition of the Section 6653(a) penalty. Leggio v. Commissioner, P-H Memo T.C., par. 65,075 (1965). Likewise, that failure to keep and maintain such records "necessary to form a rational basis for the income reported and the expenses deducted" will sustain a finding of negligence under Section 6653(a). Marcello v. Commissioner, 380 F. 2d 499, 507 (C.A. 5, 1967), cert. denied, 389 U.S. 1044 (1968). The Tax Court was therefore correct when it held taxpayer liable for the penalty under Section 6653(a).

CONCLUSION

For the reasons stated above, the decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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APRIL, 1975.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on appellant, appearing pro se, by mailing four copies thereof on this _____ day of April, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

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Attorney

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 6001. NOTICE OR REGULATIONS REQUIRING RECORDS,
STATEMENTS, AND SPECIAL RETURNS.

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

SEC. 6653. FAILURE TO PAY TAX..

(a) Negligence or Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.-- If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

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Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.6001-1 Records.

(a) In general. Except as provided in paragraph (b) of this section, any person subject to tax under subtitle A of the Code, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

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(e) Retention of records. The books or records required by this section shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law.